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SUBJECT: IMF REVIEW TEAM ON TURKEY'S STATUS

Classified By: Ambassador Ross Wilson for reasons 1.4(b) and (d)

¶1. (C) Summary: On October 15, Ambassador hosted G7 ambassadors for a readout by IMF Turkey Desk Chief Lorenzo Giorgianni and new IMF Resident Representative Hossein Samiei. The IMF team expressed concern about a lack of focus on economic policy by the government since the July election and confusion over roles in the new economic team. Spending is off track and Turkey will miss its 6.5 percent primary fiscal surplus target by a wide margin. The team pressed the government on the need for social security, energy, tax administration, and labor market reforms, but did not have a clear idea yet what the government's priorities would be, or how the government sees its IMF relationship after the current program expires in May 2008. End Summary.

¶2. (C) IMF Mission Team Leader Lorenzo Giorgianni outlined his impressions from the Mission's ongoing meetings that are its first since the July election. The government appears focused on political issues and is not taking advantage of its honeymoon period to push forward needed economic reforms. The new GOT economic team appears unsure who is in charge of which issues, while it is trying to finalize the 2008 budget and move forward on reforms that will be expensive and unpopular.

¶3. (C) Economic growth has softened to five percent. Giorgianni believes that more effective policies could push this up to seven percent per year. (The GOT estimates 5.5 percent growth in 2008.) Stubbornly high inflation (seven percent versus four percent target), high interest rates, and an appreciating lira are drags on growth. Hitting the four percent target will require very strong fiscal discipline or continued high interest rates. Spending is far off track and Giorgianni was not sure if the new government remained committed to maintaining fiscal discipline. Turkey will miss its 6.5 percent of GNP primary fiscal target this year due to both excessive spending and poor revenue collection. It will likely achieve only 4 percent in 2007, and it will drop the target to 5.5 percent for 2008.

¶4. (C) The economic team of the first AKP government, led by Economy Minister Babacan, was stronger and more cohesive than its successor. State Minister for Economy Ekren leads the new team with Treasury Minister Simsek and Finance Minister Unakitan. Roles and responsibilities, so far, do not seem to be clearly defined. We noted that Simsek is a relative newcomer to politics, and that he will have a difficult time replacing Babacan and his close relationship with the Prime Minister.

¶5. (C) On October 17, the AKP will present its 2008 budget submission, which will be a first test of commitment to

continued reform and fiscal prudence. Giorgianni said that they had raised four priority reforms with the government: the Social Security reform package; energy sector privatization and deregulation; tax administration; and labor market reform.

¶16. (C) The Social Security reform package has been revised to meet Constitutional Court objections. It is ready to be submitted to the Parliament, but the Mission was unable to get a timetable from the government for its actual submission.

¶17. (C) Turkey is facing a severe energy crisis, with electricity demand outstripping supply. Electricity prices have been frozen for five years, giving no incentive for new investment. Municipalities do not pay the state distribution company for their electricity, producing billions in losses. The GOT knows that it needs private sector investment to build capacity to meet this looming shortage, but fears the political backlash of raising rates sharply. The GOT also knows any reform must include a mechanism to force municipal and provincial entities to pay their bills to other state entities. The IMF supports proceeding with long-delayed privatizations and selling distribution and production facilities together.

¶18. (C) Revenue collection is perennially weak. During the elections many taxpayers took a tax holiday, knowing that no one was likely to come after them. To reduce marginal tax rates while increasing collections is another expensive but necessary reform.

¶19. (C) Turkey's labor markets are costly and uncompetitive. Employers pay 39-45 percent of every formal sector salary in taxes--the highest level in the OECD. The result is that many companies turn to informal employees to fill out their labor pools. Companies that strictly follow the rules do so at a higher cost than their competitors. Reforms in this area will be expensive, as they will reduce revenue initially but over time will reduce both unemployment and informality.

¶110. (C) In visits last week to Istanbul, the IMF heard pleas from investment banks and corporate leaders for continuing IMF involvement in Turkey. Giorgianni noted that the government has not indicated whether it wanted to continue its IMF relationship or in what capacity. The options range from a continuation of the current stand-by program to a post-program monitoring relationship. Giorgianni said he thought Turkey might be interested in a newly-proposed Rapid Access Line program, in which countries with good economic progress would have an open credit line with the IMF that they could draw on immediately if needed. That program has not yet been approved by the IMF board.

¶111. (C) Comment: Giorgianni asked whether we see the same lack of coordination and focus on economic issues. In our view, the GOT is focused on political priorities, including international issues like the PKK and the Armenian Genocide resolution, that not only push economic concerns to the side but also make engagement with an international institution like the IMF more difficult politically. We also discussed linkages between the IMF program and EU accession, where political issues like Cyprus and Section 301 similarly threaten to push economic reforms to the back burner. Treasury Minister Simsek is very smart, but politically inexperienced. He will have difficulty filling the shoes of former Economy Minister Babacan, who has spent years in politics and enjoys a very close relationship with the Prime Minister.

¶112. (C) In a pull-aside, Giorgianni said that it was possible the Mission would not be able to reach agreement with the government this week, and that the Mission would continue after the Bank and Fund Annual meetings in Washington. We indicated our willingness to meet and discuss events again if he thought it useful. End comment.

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